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No. 250

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

OX FIBRE BRUSH COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

U.S. GOVERNMENT PRINTING OFFICE: 1929

INDEX

Petition:

	Page
Statement	1
Specification of errors to be urged	5
Reasons for granting the writ	6

Brief in support of the petition:

Opinions below	7
Jurisdiction	8
Question presented	8
Statute involved	8
Statement	9
Argument	9
Conclusion	12

CITATIONS

Cases:

Bogle & Co., W. S., v. *Commissioner*, 26 F. (2d) 771	6, 11
Old Colony Trust Co. v. *Commissioner*, No. 130, October Term, 1928	8
United States v. *Anderson*, 269 U. S. 422	6, 10

Statutes:

Revenue Act of 1918, c. 18, 40 Stat. 1057—

Sec. 212 (b)	8
Sec. 234 (a)	9

In the Supreme Court of the United States

OCTOBER TERM, 1929

No. ——

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

OX FIBRE BRUSH COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

PETITION

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit entered in the above cause on April 16, 1929, reversing the decision of the United States Board of Tax Appeals.

STATEMENT

This case reached the Circuit Court of Appeals on the petition of the respondent, Ox Fibre Brush Company, for a review of the decision of the Board of Tax Appeals in determining an additional tax

upon respondent's income and profits taxes for the calendar year 1920. (R. 25.)

The question in the case is whether extra compensation paid to the president and treasurer of taxpayer corporation in 1920, pursuant to resolutions of its board of directors passed in that year, for services rendered in prior years, is deductible in that year as an ordinary and necessary expense in carrying on the business (taxpayer's books being kept upon the accrual basis). (R. 17.)

J. H. Robinson, Jr., and Alfred McEwen were, during 1920, and had been since 1905 and 1907, respectively, president and treasurer of taxpayer corporation. When they assumed control of the corporation in 1907 the factory was in a chaotic state and operated at a loss. In a large measure due to their efforts, the corporation progressed to a position among the foremost in the brush trade and was frequently urged by competitors to buy out or combine with the latter. (R. 15.)

During the entire period aforesaid Robinson and McEwen devoted all of their time to the promotion of taxpayer's interests, performing their duties primarily at the executive offices and living in or near New York. From 1917 to and including 1920, in addition to their regular duties they handled all large purchases, directed all sales, directed the hiring of personnel, and directed the policies of respondent and lines of factory development, including the general management of the factory. (R. 15, 31–35.)

The annual salaries of Robinson and McEwen for 1920 were $12,000 and $15,000, respectively. Respondent's board of directors at a meeting held May 6, 1920, unanimously voted to pay Robinson and McEwen additional compensation of $24,000 each as extra compensation for their past services to the company. The minutes of the meeting, so far as pertinent, are as follows (R. 16):

> This meeting having been specially called for the purpose of considering and acting upon the proposal for a grant of additional compensation to Mr. J. K. Robinson, Jr., and to Mr. Alfred McEwen, for their past services to the company, * * *.
>
> *Resolved,* That this Board hereby authorize and direct the payment of the sum of Twenty Four Thousand ($24,000) Dollars to Mr. J. K. Robinson, Jr., as extra compensation for his past services to this company as an officer thereof, and in any other capacity, the same to be paid when in the discretion of the officers, funds of this corporation for this purpose are available.
>
> *Resolved,* That this Board authorizes and directs the payment of the sum of Twenty Four Thousand ($24,000) Dollars, to Mr. Alfred McEwen as extra compensation for his past services to this company as an officer thereof and in any other capacity, the same to be paid when in the discretion of the officers, funds of this corporation for this purpose are available.

Proper book entries were made charging expense and crediting the accounts of the president and treasurer with the additional compensation voted and paid. (R. 17, 44.)

The Commissioner of Internal Revenue disallowed the deduction of the extra compensation totaling $48,000 as an expense for the year 1920. (R. 18.)

The Board of Tax Appeals took the view that the extra compensation was intended as salary for the year 1920, but that the impelling influence in determining the amount to be paid was the services rendered prior to that year. (R. 19.)

In the Circuit Court of Appeals, the Commissioner took the position that the extra compensation so voted was in consideration of services rendered in years prior to 1920 and not for 1920 services. The court accepted this view of the facts, the opinion reading as follows (R. 51):

> First, to say that the additional compensation voted to the Company's president and treasurer in 1920 was intended to be as and for, and was as and for, salaries for the year 1920, is to torture the very language of the resolutions themselves. The payment to each officer is expressly stated to be "extra compensation for his past services," not merely *measured* by such services. The wording could scarcely be clearer. (Italics supplied by the court.)

There appears to be no evidence to sustain the view of the Board that the extra compensation was

intended as 1920 salary, and the Board's conclusions in that respect are not only contradicted by the resolution of the board of directors already quoted, but also by evidence introduced by the taxpayer. A letter of Mr. Coblentz, one of the directors (R. 40), shows that he believed that the compensation was for past services, and an examination of the testimony of Mr. Crawford, another director (R. 41, 43–44), confirms that conclusion.

Adopting the view that the compensation was for services performed in prior years, it is conceded on behalf of the Commissioner that the payments were reasonable for such services. The sole question is, therefore, whether they were properly deductible in 1920. It is that question which was decided by the Circuit Court of Appeals.

If the deduction is disallowed, the resultant increase in tax for 1920 will amount to $24,091.60. (R. 24.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred in deciding that, where taxpayer's books were kept upon the accrual basis, compensation paid to officers of taxpayer corporation in 1920 (pursuant to resolutions of board of directors passed in that year) for services rendered in prior years was deductible in 1920 as an ordinary and necessary expense in carrying on the business in determining income and excess profits taxes for that year.

REASONS FOR GRANTING THE WRIT

(1) The decision in the present case is in conflict with the decision of the United States Circuit Court of Appeals for the Seventh Circuit in the case of *W. S. Bogle & Co.* v. *Commissioner,* 26 F. (2d) 771. The latter court decided (p. 772):

> Where a salary has been fixed and fully paid for one year, it can not be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year.

(2) The decision of the Circuit Court of Appeals in the instant case approves a deduction for the year 1920 of an expenditure which had no relation to 1920 income and is out of harmony with the decision of this Court in *United States* v. *Anderson,* 269 U. S. 422, 440. In that case the purpose of Congress in providing for tax returns on an accrual basis was stated in the following language (p. 440):

> It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.

(3) The question is of present importance in administering the tax laws since it is involved in cases now pending in the courts, the Board of Tax Appeals and before the Bureau of Internal Revenue. Without a decision of this Court, the Commissioner of Internal Revenue is unable to determine the proper principle to be applied to such cases, and an acceptance of the decision in the present case would leave the matter in confusion. Although existing Revenue Acts no longer include excess-profits taxes, nevertheless the possibility of reductions in surtaxes or additional exemptions of earned income of individuals, as well as of changed rates as applied to corporation income taxes, indicate the probable continuing importance of the question.

Wherefore, it is respectfully submitted that the petition should be granted.

CHARLES E. HUGHES, Jr.,
Solicitor General.

JULY, 1929.

BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the United States Circuit Court of Appeals is reported in 32 F. (2d) 42 and will also be found in the record (p. 49).

The findings of fact and opinion of the Board of Tax Appeals (R. 15) are reported in 8 B. T. A. 422.

JURISDICTION

The order of the Circuit Court of Appeals affirming the decision of the Board of Tax Appeals was entered on April 16, 1929. (R. 57.)

Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925. (See also decision of this Court in *Old Colony Trust Co.* v. *Commissioner of Internal Revenue,* No. 130, October term, 1928.)

QUESTION PRESENTED

Where extra compensation has been paid to officers of taxpayer corporation in 1920 (pursuant to resolutions of its board of directors passed in that year) but where such compensation is in consideration of services rendered in prior years, is such compensation deductible in 1920 as an ordinary and necessary expense in carrying on the business (taxpayer's books being kept upon the accrual basis)?

STATUTE INVOLVED

The Revenue Act of 1918, c. 18, 40 Stat. 1057, provides in part:

> SEC. 212. (b) The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect income, the computation shall be made upon such basis and in such manner as in the opinion of the Commis-

sioner does clearly reflect the income. * * *

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered * * *.

STATEMENT

A statement of the facts and of the errors relied on will be found in the petition.

ARGUMENT

The Circuit Court of Appeals holds that since the corporation's books were kept on an accrual basis, and the extra compensation was not voted by its board of directors until 1920, an application of the ordinary rule that expenses due will not accrue until all of the factors material to the liability have become fixed necessitated the conclusion that such compensation accrued in 1920, although the court recognized that it was paid for services rendered in prior years. (R. 51.)

The court, in its literal adherence to the accrual theory, closes its eyes to the requirement of Section 212 (b) of the Revenue Act of 1918, *supra*, that net income shall be computed according to taxpay-

er's regular method of accounting, if that accounting method clearly reflects income; but that, if it does not, the computation is to be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect income.

The basic purpose is always the clear reflecting of income. This was recognized in *United States* v. *Anderson,* 269 U. S. 422, 440, where this Court stated that the purpose of Congress in permitting returns on other than a cash basis was to enable taxpayers to make their returns on scientific accounting principles by charging against income earned during the taxable period the expenses properly attributable to the process of earning income during that period.

In the present case, the extra compensation was earned in years prior to 1920. It had no relation whatever to the earning of income in 1920. Its deduction in that year is sought solely because the board of directors delayed action until that time.

If the taxpayer's contention is sound it results that the directors could have chosen arbitrarily any year subsequent to those in which the compensation was actually earned. Following this contention to its logical conclusion would enable corporations to deduct expenses for salaries when and as they choose. Such expenses might be shifted from year to year or averaged in whatever way expediency might dictate. Such expediency might well dictate the selection of years which would result in a lower

tax. In years in which excess profits taxes were levied this result could be accomplished by concentrating expenses in a single year in order to bring income to a lower classification in the graduated rating. In any period of decreasing rates of taxes the result could be accomplished by delaying the payment of large salaries until years of lower rates, thereby benefiting the individuals receiving compensation from close corporations.

Arbitrary shifting of expenses, therefore, results in failure clearly to reflect income for tax purposes. The Circuit Court of Appeals for the Seventh Circuit foresaw this difficulty. In *W. S. Bogle & Co. v. Commissioner*, 26 F. (2d) 771, that court said (p. 772):

> Where a salary has been fixed and fully paid for one year, it can not be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year.

The decision in the *Bogle case, supra,* is in direct conflict with the present case. The court in the instant case recognizes at least a *prima facie* conflict, but suggests that since in the *Bogle case, supra,* the court spoke of a salary "fixed and fully paid," there may be implied from that statement the fact that the additional compensation was unreasonable. Nothing in the Bogle opinion suggests such a basis for the decision, and the opinion in the present case concedes the suggested distinction to be a doubtful one. (R. 54.)

The result of the conflict of decision leaves in doubt the proper course to be followed by the Commissioner with respect to an important problem in the administration of the tax laws.

CONCLUSION

Because of the conflict of decisions involving a principle of present importance in administering the income tax laws, it is urged that this Court grant the petition in order that there may be a conclusive determination of the question.

Respectfully submitted.

CHARLES E. HUGHES, Jr.,
Solicitor General.

MORTON P. FISHER,
Special Assistant to the Attorney General.

DOROTHY A. MONCURE,
Attorney.

JULY, 1929.

U. S. GOVERNMENT PRINTING OFFICE: 1929

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No. 250

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

OX FIBRE BRUSH COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	3
Specification of error to be urged	6
Summary of argument	7
Argument	9
Conclusion	20
Appendix	21

CITATIONS

Cases:	
Adams, Payne & Gleaves, Inc., v. *Commissioner*, 9 B. T. A. 1076; affd., 31 F. (2d) 1006	20
American National Co. v. *United States*, 274 U. S. 99	15
Bogle & Co., W. S., Appeal of, 5 B. T. A. 541; affd., 26 F. (2d) 771	8, 12, 19
Cushman Manufacturing Co., Appeal of, 2 B. T. A. 39	19
De Loss v. *Commissioner*, 28 F. (2d) 803	9, 16
Flint River Brick Co., Appeal of, 2 B. T. A. 31	19
Green Oil Soap Co., Appeal of, 3 B. T. A. 467	19
Lihue Plantation Co., Ltd., Appeal of, 2 B. T. A. 740	19
Lucas, Robert H., Commissioner, v. *American Code Company, Inc.*, No. 67, October Term, 1929	17
Model Dairy, Inc., v. *Commissioner*, 13 B. T. A. 545; affd., December 10, 1929	8, 16, 20, 21
Nailove & Co. v. *Commissioner*, 32 F. (2d) 949; certiorari denied, October 21, 1929	17
Rock Island Sash and Door Works v. *Commissioner*, 13 B. T. A. 635	19
Roubaix Mills, Inc., v. *Commissioner*, 7 B. T. A. 878	19
United States v. *Anderson*, 269 U. S. 422	7, 9, 13–15
Vaughan & Barnes, Inc., v. *Commissioner*, 6 B. T. A. 1279; affd., 31 F. (2d) 1006	20
Wise Realty Corp. v. *Commissioner*, 5 B. T. A. 796	20
Statutes:	
Revenue act of 1918, c. 18, 40 Stat. 1057, 1064, 1065, 1077—	
Sec. 212 (b)	2, 10
Sec. 234 (a)	2
Miscellaneous:	
C. B. VI–1, January–June, 1927, p. 205	19

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The findings of fact and opinion of the United States Board of Tax Appeals (R. 8) are reported in 8 B. T. A. 422.

The opinion of the United States Circuit Court of Appeals (R. 32) is reported in 32 F. (2d) 42.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 16, 1929. (R. 41.) Petition for certiorari was filed July 15, 1929. (R. 43.) Certiorari was granted October 21, 1929. (R. 43.)

Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where taxpayer's books are kept upon the accrual basis, and where extra compensation has been paid to officers of taxpayer corporation in 1920 (pursuant to resolutions of its board of directors passed in that year), but where such compensation is for services rendered in prior years, is such compensation deductible in 1920 as an ordinary and necessary expense in carrying on the business?

STATUTE INVOLVED

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1064, 1065, 1077, provides in part:

> SEC. 212. (b) The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *
>
> * * * * *
>
> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable

year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered * * *;

* * * * *

STATEMENT

This case reached the Circuit Court of Appeals on the petition of the respondent, Ox Fibre Brush Company, for a review of the decision of the Board of Tax Appeals in determining an additional tax upon respondent's income and profits for the calendar year 1920. (R. 16.)

J. K. Robinson, Jr., and Alfred McEwen were, during 1920, and had been since 1905 and 1907, respectively, president and treasurer of taxpayer corporation. When they assumed control of the corporation in 1907 the factory was in a chaotic state and operated at a loss. In a large measure due to their efforts, the corporation progressed to a position among the foremost in the brush trade and was frequently urged by competitors to buy them out or to combine with them. (R. 9.)

During the entire period aforesaid Robinson and McEwen devoted all of their time to the promotion of taxpayer's interests, performing their duties primarily at the executive offices and living in or near New York. From 1917 to and including 1920, in addition to their regular duties they handled all large purchases, directed all sales, directed the hiring of personnel, and directed the policies of

respondent and lines of factory development, including the general management of the factory. (R. 9, 19–23.)

The annual salaries of Robinson and McEwen for 1920 were $12,000 and $15,000, respectively. (R. 10.) Respondent's board of directors at a meeting held May 6, 1920, unanimously voted to pay Robinson and McEwen additional compensation of $24,000 each as extra compensation for their past services to the company. The minutes of the meeting, so far as pertinent, are as follows (R. 10):

> This meeting having been specially called for the purpose of considering and acting upon the proposal for a grant of additional compensation to Mr. J. K. Robinson, Jr., and to Mr. Alfred McEwen, for their past services to the company, * * *
>
> Resolved that this board hereby authorize and direct the payment of the sum of twenty-four thousand ($24,000) dollars to Mr. J. K. Robinson, jr., as extra compensation for his past services to this company, as an officer thereof and in any other capacity, the same to be paid when, in the discretion of the officers, funds of this corporation for this purpose are available.
>
> Resolved that this Board authorizes and directs the payment of the sum of twenty-four thousand ($24,000) dollars, to Mr. Alfred McEwen as extra compensation for his past services to this company as an officer thereof and in any other capacity, the same

> to be paid when in the discretion of the officers, funds of this corporation for this purpose are available.

Proper book entries were made charging expense and crediting the accounts of the president and treasurer with the additional compensation voted and paid. Taxpayer's books were kept on the accrual basis. (R. 10.)

The Commissioner of Internal Revenue disallowed the deduction of the extra compensation totaling $48,000 as an expense for the year 1920. (R. 11.)

The Board of Tax Appeals took the view that the extra compensation was intended as salary for the year 1920, but that the impelling influence in determining the amount to be paid was the services rendered prior to that year. (R. 12.)

In the Circuit Court of Appeals, the Commissioner took the position that the extra compensation so voted was in consideration of services rendered in years prior to 1920 and not for 1920 services. The court accepted this view of the facts, the opinion reading as follows (R. 35):

> First, to say that the additional compensation voted to the company's president and treasurer in 1920 was intended to be as and for, and was as and for, salaries for the year 1920, is to torture the very language of the resolutions themselves. The payment to each officer is expressly stated to be "extra

compensation for his past services," not merely measured *by* such services. The wording could scarcely be clearer.

There appears to be no evidence to sustain the view of the Board that the extra compensation was intended as 1920 salary, and the Board's conclusions in that respect are not only contradicted by the resolution of the board of directors already quoted, but also by evidence introduced by the taxpayer. A letter of Mr. Coblentz, one of the directors (R. 26), shows that he believed that the compensation was for past services, and an examination of the testimony of Mr. Crawford, another director (R. 27–29), confirms that conclusion.

Adopting the view that the compensation was for services performed in prior years, it is conceded on behalf of the Commissioner that the payments were reasonable for such services. The sole question is, therefore, whether they were ordinary and necessary expenses deductible in 1920. It is that question which was decided adversely to the Commissioner by the Circuit Court of Appeals.

If the deduction is disallowed, the resultant increase in tax for 1920 will amount to $24,091.60. (R. 15.)

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in deciding that, where taxpayer's books were kept upon the accrual basis, compensation paid to officers of taxpayer corporation in 1920 (pursuant to resolutions

of board of directors passed in that year) for services rendered in prior years was deductible in 1920 as an ordinary and necessary expense in carrying on the business in determining income and excess-profits taxes for that year.

SUMMARY OF ARGUMENT

It has been the intention of Congress in enacting income tax legislation that the tax be levied upon the taxpayer's true net income for the prescribed accounting period. *United States* v. *Anderson*, 269 U. S. 422. In order to carry out that intent, Section 212 (b) of the Revenue Act of 1918 provided that net income be computed in accordance with taxpayer's regular method of accounting, if that method clearly reflected income; but that if it did not, the computation was to be made upon such basis and in such manner as in the opinion of the Commissioner did clearly reflect income.

In the present case taxpayer seeks the deduction for the year 1920 of extra compensation paid to two of its officers for services rendered over a period of years prior to 1920. The extra compensation was not voted until 1920. There was no agreement that such extra compensation be paid, and until voted by the board of directors there was no basis for any claim therefor.

The Circuit Court of Appeals held that the extra compensation could be deducted by the corporation as an expense in 1920 because it was voted in that

year. The court based its decision upon the theory that since taxpayer's books were on the accrual basis the liability must accrue and be deductible in the year in which all of the factors material to the liability became fixed.

It is true that under the accrual basis deductions may not always be attributed with complete accuracy to the year in which they naturally belong. Some leeway must be allowed as a practical necessity, and some overlapping from year to year is bound to occur if that basis is to be applied consistently. These necessary variations, however, usually adjust themselves over a period of years.

But there is a limit to the diversion of income or deductions from year to year beyond which a taxpayer may not go, even though the technical requirements of the accrual basis are complied with. Beyond this point, the clear reflection of income must govern as provided in Section 212 (b), *supra*.

In the present case the extra compensation not only bore no relation to the year 1920, but should have been allocated to the several years in which the services were rendered instead of being concentrated in a single year. Delay by the board of directors is the only reason why it was not so allocated. Under these circumstances, the deduction is not allowable in the year in which voted, because the true income for that year would not be clearly reflected. See *W. S. Bogle & Co.* v. *Commissioner* (C. C. A. 7th), 26 F. (2d) 771, 772; *Model Dairy,*

Inc., v. *Commissioner* (C. C. A. 8th), decided December 10, 1929, not yet reported (Appendix, p. 21). This view is consistent with the congressional intent that taxes be levied upon the true net income. *United States* v. *Anderson, supra.* See also *De Loss* v. *Commissioner* (C. C. A. 2d), 28 F. (2d) 803, 805.

Arbitrary shifting of deductions from year to year enables the taxpayer to escape the full tax intended to be levied and interferes with the accomplishment of the intention of Congress to levy taxes in accordance with the present needs of the Government.

It is urged, therefore, that the extra compensation is not properly allowable as a deduction in the year 1920.

ARGUMENT

The Circuit Court of Appeals in the present case decided that the taxpayer was entitled to deduct as an ordinary and necessary expense in 1920, extra compensation, voted to its officers in 1920, for services performed during a period of years prior to the year 1920. The regular annual salaries of the two officers for 1920 were $12,000 and $15,000, respectively. (R. 10.) The regular salaries paid to the same officers in prior years never exceeded those amounts, and the same salaries were paid in the succeeding year. The extra compensation to each in 1920 was $24,000. Normally, this extra compensation would have been voted and paid to the officers and deducted as an expense in the several years

during which the services were rendered. The board of directors, however, failed to appropriate the extra compensation until 1920. There was no agreement that the extra compensation was to be paid, and, until voted by the board of directors, there was no basis for a claim therefor on the part of the officers.

The Circuit Court of Appeals held that since the corporation's books were kept on the accrual basis, and the extra compensation was not voted by its board of directors until 1920, an application of the rule that expenses will not accrue until all of the factors material to the liability have become fixed necessitated the conclusion that such compensation accrued as an expense and was deductible in 1920, although the court recognized that it was paid for services rendered in prior years.

The court, however, fails to take into consideration the requirement of Section 212 (b) of the Revenue Act of 1918, *supra,* to the effect that net income shall be computed according to taxpayer's regular method of acounting, if that accounting method clearly reflects income; but that if it does not, the computation is to be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect income.

For the convenience of the Court, the relevant provisions of Section 212 (b), *supra,* are repeated here as follows:

> The net income shall be computed * * * in accordance with the method of accounting

> regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

It is true that the consistent application of the accrual basis of accounting at times necessarily results in the taxing of income or the allowance of deductions in years to which such income or deductions would not otherwise be attributable. There is bound to be some overlapping from one year to another, and deductions may not always be attributed with complete accuracy to the year in which they may naturally belong. In most instances, however, these necessary variations adjust themselves over a period of years, and some leeway must be allowed as a practical necessity.

But there must be a limit to the diverting of income or deductions from one year to another beyond which a taxpayer may not be permitted to go, even though the requirements of the accrual basis may be technically complied with. Beyond that limit, the clear reflection of income must govern as provided in Section 212 (b), *supra*. The purpose of the provision relating to the clear reflection of income is to enable the Commissioner to carry out as nearly as may be the basic principle of the income tax laws, which is to levy a tax upon the true net income for the taxable year.

In the present case, the extra compensation not only bore no relation to the year 1920, but it involved payments in that year which normally would be fixed and incurred in each of the several years during which the services were rendered.

The delay until 1920 was due to the failure of the board of directors to vote the additional compensation in the years in which it was earned. There is no reason why appropriations could not have been made in each of the several years during which the services were rendered at least approximating their value. To allow the deduction to be concentrated in 1920 is to prevent the determination of the true net income for that year, and the cause of the departure from basic principle is the voluntary and avoidable delay on the part of the taxpayer.

The reasoning here advanced is supported by the decision of the Circuit Court of Appeals for the Seventh Circuit in the case of *W. S. Bogle & Co.* v. *Commissioner,* 26 F. (2d) 771. The court said, in its opinion (p. 772):

> Where a salary has been fixed and fully paid for one year, it can not be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year.

The court in the instant case recognized that there is at least a *prima facie* conflict with the *Bogle case,* but suggested that since in the *Bogle case* the court spoke of a salary "fixed and fully paid," there may be implied from that statement

the fact that the additional compensation was unreasonable. Nothing in the *Bogle* opinion suggests such a basis for the decision, and the opinion in the present case conceded the suggested distinction to be a doubtful one. (R. 37–38.) In the present case the regular salaries were accepted by the officers prior to 1920, and the extra compensation granted was entirely voluntary and not based upon prior agreement or present consideration.

The position of the Government in the instant case is consistent with the principles laid down by this Court in *United States* v. *Anderson,* 269 U. S. 422. In that case the Court had occasion to construe the provisions of the Revenue Act of 1916 which correspond to Section 212 (b) of the Revenue Act of 1918. There it was held that a munitions tax imposed for the year 1916 and payable in 1917 was an incurred liability for 1916 and must be deducted by the corporation, accounting on the accrual basis, from gross income of 1916, like other items of expense chargeable to the income of that year. The Court, considering the purpose of Congress to tax actual net income, recognized that if the true net income reported upon the accrual basis is to be clearly reflected there must be deducted from the gross income of the year all the expenses incurred during the year and attributable to the process of earning the income against which they are charged. The language of the Court is as follows (p. 437):

> While Section 12 (a) taken by itself would appear to require the income tax return to be made on the basis of actual receipts and disbursements, it is to be read with Section 13 (d) * * * by providing in substance that a corporation keeping its books on a basis other than receipts and disbursements, may make its return on that basis provided it is one which reflects income.

The Court further said (p. 439):

> Treasury Decision 2433 * * * recognized the right of the corporation to deduct all accruals * * * made on its books to meet liabilities, provided the return included income accrued and, as made, reflected true net income.

And again (p. 440):

> A consideration of the difficulties involved in the preparation of an income account on a strict basis of receipts and disbursements * * * indicates with no uncertainty the purpose of Sections 12 (a) and 13 (d) * * * to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.

> The appellee's true income * * * could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year.

The Court added (p. 441):

> In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the [munitions] taxes had accrued. It should be noted that Section 13 (d) makes no use of the words "accrue" or "accrual" but merely provides for a return upon the basis upon which the taxpayer's accounts are kept, if it reflects income * * *. We do not think that the Treasury decision contemplated a return on any other basis when it used the terms "accrued" and "accrual" and provided for the deduction by the taxpayer of items "accrued on their books."

In *American National Co.* v. *United States,* 274 U. S. 99, this Court again stated and applied the principle announced in the case last cited. Thus this Court has explicitly interpreted the basic purpose of the Revenue Acts and declared the controlling principle applicable to claimed deductions from gross income.

It is this fundamental principle of taxing the true net income which the Circuit Court of Appeals for the Fourth Circuit has failed to recognize and give effect in the instant case. The additional salaries

authorized by the respondent in 1920 were for services rendered in years prior thereto, and certainly were not expenses logically attributable to the year 1920. The Circuit Court of Appeals, however, assumed that since there could be no deduction until all the events occurred that fixed the liability, it must necessarily follow that the happening of all the events authorizes a deduction. It is urged, for the reasons already stated, that the premise adhered to so rigidly by the Circuit Court of Appeals must give way to the statutory requirement of a clear reflection of income, and the basic principle of taxing the true net income, in cases where the concentration of deductions in a single year not only prevents the taxation of the true net income, but finds no basis in practical necessity.

An expression of this principle is found in the opinion of the Circuit Court of Appeals for the Second Circuit in *De Loss* v. *Commissioner,* 28 F. (2d) 803. The court said (p. 805):

> Although it is, of course, true that anyone is entitled to spread his losses as best he can in order to reduce his taxes, in interpreting the law we are not to assume that a system based upon yearly gains and losses was so contrived as to admit deviations in principle which must always operate to the taxpayer's advantage.

In the case of *Model Dairy, Inc.,* v. *Commissioner of Internal Revenue,* decided December 10, 1929 (Appendix, p. 21), the Circuit Court of Appeals for

the Eighth Circuit declined to follow the decision of the Circuit Court of Appeals for the Fourth Circuit in the instant case and, construing the literal language of the statute, held that the services paid for must have been actually rendered in the year for which the allowance is claimed. It is not necessary to go so far in this case, however, since it may be decided on the principle that the incurrence of an expense must have a normal relationship in point of time to the benefit represented by the expenditure, or, to state it differently, that the taxpayer's method of accounting must reflect, and not distort, its net income.

The result of the Government's position here, coupled with that taken by it in *Robert H. Lucas, Commissioner,* v. *American Code Company, Inc.,* No. 67, October Term, 1929, is that under the particular facts of this case the taxpayer has placed itself in a position where no deduction can properly be allowed in any year. While it may seem a hardship to deny a deduction for an expense which perhaps might have been taken had the taxpayer in the earlier years authorized the increased salaries (*cf. Naitove & Co.* v. *Commissioner,* 32 F. (2d) 949, certiorari denied, October 21, 1929), the Revenue Acts must be applied to facts as they actually occur, without reference to what might have been done had the facts been different. There are many cases in which the tax liability varies according to the form that the transaction actually takes.

It is of the greatest practical importance that the arbitrary shifting of deductions from one year to another be prevented. If a corporation were allowed to do so, it would be easy for its board of directors to concentrate deductions in the year in which the corporation might derive the greatest benefit through reduction of taxes. In the period during which excess profits taxes were levied, if deductions were shifted from years in which small profits were earned to years in which the profits were large a substantial saving would result through avoiding taxation at the higher classification in the graduated rates. In any period of changing rates, whether increasing or decreasing, similar results may be accomplished for the benefit of the corporation or its officers.

Moreover, the requirement for an annual accounting of the true income has a more fundamental basis. Taxes and tax rates are based as nearly as may be upon the needs of government. During the period of the war the need was great, and we find excess and war profits taxes, surtaxes, and, in general, graduated rates applied to larger incomes. When the need passed, excess and war profits taxes were eliminated and graduated rates reduced. If Congress intends to adjust taxes to the needs of government, its intention must fail of its best accomplishment unless regular accounting periods are adopted and arbitrary shifting of income or deductions is prevented.

It must be admitted that cases involving questions similar to that in the present case have not received consistent treatment. In an opinion which appears in C. B. VI–1, January–June, 1927, p. 205, Mr. Gregg, then General Counsel, Bureau of Internal Revenue, took the view here asserted by taxpayer, referring to several decisions of the Board of Tax Appeals in which the Commissioner of Internal Revenue acquiesced. See *Appeal of Flint River Brick Co.*, 2 B. T. A. 31; *Appeal of Lihue Plantation Co., Ltd.*, 2 B. T. A. 740, and others. In those cases, however, the Board seems to have reached its conclusion upon the theory that the salaries were reasonable in the year in which deducted although measured on the basis of services rendered in prior years, and has continued to apply this theory in some later cases. *Roubaix Mills, Inc.*, v. *Commissioner*, 7 B. T. A. 878; *Rock Island Sash and Door Works* v. *Commissioner*, 13 B. T. A. 635.

On the other hand, in cases where it was clear that additional salaries were paid in later years expressly for services rendered in prior years—similar to the "extra compensation for * * * past services" here involved—the Board has held in favor of the present contention of the Commissioner, and refused to allow the deduction. See *Appeal of H. T. Cushman Manufacturing Co.*, 2 B. T. A. 39; *Appeal of Green Oil Soap Co.*, 3 B. T. A. 467; *Appeal of W. S. Bogle & Co.*, 5 B. T. A. 541, 551 (affirmed, C. C. A. 7th, 26 F. (2d)

771), *supra; Wise Realty Corp.* v. *Commissioner*, 5 B. T. A. 796; *Vaughan & Barnes, Inc.*, v. *Commissioner*, 6 B. T. A. 1279; *Adams, Payne & Gleaves, Inc.*, v. *Commissioner*, 9 B. T. A. 1076 (affirmed *per curiam*, C. C. A. 4th, 31 F. (2d) 1006); *Model Dairy, Inc.*, v. *Commisisoner*, 13 B. T. A. 545 (affirmed, December 10, 1929, C. C. A. 8th, not yet officially reported), *supra*.

CONCLUSION

For the reasons stated, it is urged that the Circuit Court of Appeals erred in allowing the extra compensation to be deducted as an ordinary and necessary expense in 1920, and the decision of that court should therefore be reversed.

Respectfully submitted.

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JANUARY, 1930.

APPENDIX

UNITED STATES CIRCUIT COURT OF APPEALS, EIGHTH CIRCUIT

No. 8482.—November Term, A. D. 1929

Model Dairy, Incorporated, appellant,

vs.

Commissioner of Internal Revenue, appellee

On petition to review decision of the United States Board of Tax Appeals.

Mr. Benjamin H. Flesher for appellant.

Mr. John H. McEvers, Special Assistant to the Attorney General (Mrs. Mabel Walker Willebrandt, Assistant Attorney General; Mr. J. Louis Monarch, Special Assistant to the Attorney General; and Mr. C. M. Charest, General Counsel, Bureau of Internal Revenue, on the brief with him), for appellee.

Before KENYON and VAN VALKENBERG, Circuit Judges, and MARTINEAU, District Judge.

MARTINEAU, District Judge, delivered the opinion of the court.

This is a petition to review the decision of the United States Board of Tax Appeals. In 1919 the Model Dairy was incorporated for the purpose of handling dairy products, and in that year com-

menced business. Its business had formerly been carried on by two competing partnerships composed of five members, all of whom became officers in the new company. Salaries for 1920 and 1921 were fixed and paid to these officers under a resolution which provided that additional salaries would be paid at some future time if the company prospered. In March, 1922, a resolution was passed fixing and allowing back pay or adjusted compensation to these officers in the sum of $11,940.00, for each of the years 1920 and 1921. The amount allowed for 1920 was to be and was paid in 1922, and the back salary for 1921 was paid in 1923. These increases ranged from sixty to one hundred per cent of the salaries which had been allowed and paid in 1920 and 1921. There was also an increase in the salaries for the years 1922 and 1923, but it was not intended that the $11,940.00 was to be a part of the salarics for these years. The resolution authorizing the payment of these amounts is clear that they were intended as additional compensation or a bonus for the years 1920 and 1921.

In determining the company's income tax the Commissioner of Internal Revenue refused to allow deductions for these back salaries, either for the years in which they were paid or for the years of 1920 and 1921, and the Board of Tax Appeals has upheld that finding. The petitioner here contends that these deductions should be allowed in determining the income tax for 1922 and 1923.

Where a corporation authorizes the payment of money to its officers or employees as additional or adjusted compensation for services rendered during previous years, where there was no understanding or agreement to pay any fixed amount, or any

amount at all, are amounts thus allowed deductible in determining the net income of a corporation?

The answer to this question must be found in the construction of Section 234 of the Revenue Act of 1921, which provides that in computing the net income of a corporation there shall be deducted "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered." This provision authorizes deduction for salaries and other compensation for personal services only when actually rendered during the taxable year. To say that the phrase "during the taxable year" modifies only that part of the section preceding it, and has no reference to salaries and compensation for personal services is to give it a meaning which is clearly contrary to the language actually used. The deductions allowable were to include the ordinary and necessary expenses paid or incurred, together with salaries and other compensation for personal services actually rendered during the taxable year. Language more clearly expressing this meaning could scarcely be selected. The language used was intended to prevent deductions such as those claimed here. In *W. S. Bogle & Company* v. *Commissioner,* 26 Fed. (2d) 771, the court took this view, saying:

"This statute was intended to allow ordinary and necessary expenses paid and incurred within the year for officers' salaries. Where the salary has been fixed and fully paid for one year it can not be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year."

We are not unmindful that a different conclusion was reached in *Ox Fibre Brush Company* v. *Blair, Commissioner,* 32 Fed. (2d) 42. We are of the opinion, however, that a proper construction of the statute justifies the conclusions herein expressed.

The decision appealed from is sustained.

Filed December 10, 1929.

A true copy.

Attest:

[SEAL.] E. E. KOCH,

Clerk, U. S. Circuit Court of Appeals,
Eighth Circuit.

U. S. GOVERNMENT PRINTING OFFICE: 1930